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Income-tax Department

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Taxpayers who are subject to the risk of sustaining losses by embezzlement must be able to trace such losses to the years in which they take place if such losses are to be deducted as "losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business." If the embezzler, however, misappropriates funds of the taxpayer's clients and the taxpayer opens an account with the embezzler at the time the fraud is discovered, and the account is found to be uncollectable, then the taxpayer may deduct the amount of the uncollectable account in the year he determines that it is uncollectable.

Such is the inference that may be drawn from a decision made by the United States court of appeals, eighth circuit, in the case of *John H. Farish and Co.* v. *Commissioner of internal revenue.*

It appears from the record that the taxpayer's business principally consisted of collecting rents for clients; that a trusted employee embezzled $57,000 of funds collected from the taxpayer's clients and was called upon to make good the defalcations; that upon the discovery that only about $6,000 of the defalcations could be restored the remaining $51,000 was charged off in the year in which the defalcation was discovered and the account was found to be worthless.

Accountants were engaged after the shortage was discovered and they found that $10,000 had been embezzled in 1919 and $10,000 in 1920. The remaining $37,000 had been misappropriated prior to 1919. Confronted with this condition, the revenue agents determined that the taxpayer was entitled to deduct $10,000 in each of the years 1919 and 1920, as losses sustained and not compensated for in those years, but apparently no deduction was allowed for prior years, because it was not possible to prove just how much of the loss was sustained in each of the previous years, or, perhaps, because the statute of limitations had barred the redetermination and refund for years prior to 1919.

The court held that inasmuch as the embezzlement was of the taxpayer's clients' funds and the taxpayer had paid the clients the amounts found to be due to them, and as he had charged the amount so paid to the embezzler's account, the amount of the loss became an account receivable. This account was later found to be uncollectable as to its major part, was charged off and deducted in the taxpayer's return, and the deduction was allowed by the court.

To the lay mind it seems inconceivable that such a loss was not allowed by the commissioner at first without question, for the following reasons:

1. The facts recited by the court were known to the commissioner, when the revenue agent reported on his findings.
2. There were precedents at that time which indicated that under such conditions as were present in the case the loss was deductible as a bad debt.

The apparent obstinacy of the bureau of internal revenue seems unjustifiable. The pursuance of such a policy placed on this taxpayer the hardship and expense of employing counsel and the additional incidental costs of litigation. It is doubtful whether the taxpaying citizens expect the government to go to such lengths in pursuing a few stray tax dollars, and the treasury department's more recent policy of meeting a taxpayer halfway in the settlement of such controversies, we believe, grew out of a realization that a victory in such cases as the one under consideration reflected no credit on the government nor on those responsible for such victories.

SUMMARY OF RECENT RULINGS

Depletion and depreciation deductions on the unit-of-production basis for 1918 and 1920 on coal-mining properties may not be based on a new and corrected estimate of recoverable coal made in 1922, which new estimate may be used as a basis only for taxable years after the estimate was made. (*Kehota Mining Co.* v. *C. G. Lewellyn, former collector*, and *Kehota Mining Co.* v. *D. B. Heiner, collector*. U. S. circuit court of appeals, third circuit.)

Gain from the sale by the trustee of securities, part of a residuary trust fund bequeathed, after a life estate, to exempt charitable, etc., institutions, is exempt if such income is permanently set aside for payment to such institutions or if, by the terms of the will, the income is to be payable to charitable uses, and such income may not be taxed even though the trustee has power to divert it to non-exempt fields, until such actual diversion is made. (*The Hartford-Connecticut Trust Co., trustee of the estate of Frank C. Sumner*, v. *Robert O. Eaton, collector*. U. S. district court, district of Connecticut.)

The statutory basis under the 1921 act for sale of trust property by the trustee should be adjusted for depreciation sustained whether or not such depreciation was deducted in the return for the trust. (*Old Colony Trust Co.* v. *White*. District court of the United States, district of Massachusetts.)

No deductible loss was sustained in the amount of the excess of the cost of rebuilding in 1920 a unit of a lumbering plant destroyed by fire in 1919 and the amount of insurance collected therefor. (*Pelican Bay Lumber Co.* v. *David H. Blair, commissioner*. U. S. circuit court of appeals, ninth circuit.)

Debt resulting where a bank was compelled to make good a letter of credit issued upon an irrevocable guaranty by another bank covering a purchase by a customer of the latter, which the latter revoked and the former refused to accept, charged off in 1920, was held not to have been ascertained to be worthless within the taxable year, where the guarantor was a going banking concern not shown to be insolvent in any sense of the term, and the taxpayer brought suit against it shortly after the charge-off. (*American Trust Company, successor to American National Bank*, v. *Commissioner*. U. S. circuit court of appeals, ninth circuit.)

Where the accrual basis upon which a corporation kept its books admittedly did not reflect true net income as used in a return under the option provided in sec. 13 (d), act of 1917, in that an item of inventory otherwise valued at cost or market, whichever was lower, was valued at a constant figure regardless of changes in cost or market value, income for 1917 must be computed on the cash-receipts-and-disbursements basis. (*American Can Co.* v. *United States; Detroit Can Co.* v. *United States; Missouri Can Co.* v. *United States*. U. S. court of appeals, third circuit.)

Loss from embezzlement over a period of years by an employee of the taxpayer in the business principally of collecting rents for clients is deductible as a bad debt in the year the employer was called upon to make good the defalcations and the amount was charged off upon determining that recovery could not be made from the employee, the money embezzled being trust funds belonging to the taxpayer's clients. (*John H. Farish and Co.* v. *Commissioner*. U. S. circuit court of appeals, eighth circuit.)

A hotel serving tea in its public rooms and furnishing music for dancing without charge of any kind for dancing, is not subject to the tax imposed on roof gardens, cabarets or other similar entertainment by sec. 800 of the 1918 and 1921 acts. (*The United States of America* v. *The Broadmoor Hotel Co., a corporation*. U. S. district court, district of Colorado.)

Intangibles consisting of trade marks, trade names, trade brands and goodwill are not such property as is subject to obsolescence within the meaning of sec. 214 (a) (8), acts of 1918 and 1921.

Profit from the sale of old whiskey sold by a distiller in 1922 is not subject to the capital-gain provision of sec. 206, act of 1921, such property being stock in trade properly included in inventory.

A distillery plant became obsolescent in 1921 when the Willis-Campbell act became effective and a permit to distill medicinal whiskey was refused, and obsolescence and depreciation should be allowed on warehouses in proportion to the reduction in useful and valuable capacity during each year. That a permit to distill medicinal whiskey may be issued at some future time is a hypothetical assumption contrary to fact. (*Frederick C. Renziehausen* v. *Commissioner; Commissioner* v. *Frederick C. Renziehausen.* U. S. circuit court of appeals, third circuit.)

Two corporations were held not to be affiliated for 1920, the ownership by one company of 80% of the stock of the other not constituting ownership or control of substantially all its stock. (*Wadhams & Co.* v. *The United States.* Court of claims of the U. S.)

Profit from the sale in 1917 of realty acquired in 1915 by a corporation organized in that year to acquire the assets of two railway companies by the issue of its capital stock dollar for dollar for the outstanding stock of the predecessor corporations was determined on the basis of the value of such realty carried on the books which was the original cost price to the predecessor corporation. (*Seaboard Air Line Railway Company* v. *United States.* Court of claims of the United States.)

Amounts charged in 1920 to the chief stockholders of a corporation representing the balance of a contract which had proved worthless transferred by such stockholders to the corporation in exchange for stock, constitute contributions of capital and are not deductible by the stockholders either as a loss or as a reduction in salary, as claimed by the taxpayers. (*Warren E. Burns, Williard A. Walsh & Carl Schaetzer* v. *Commissioner.* U. S. circuit court of appeals, fifth circuit.)

A valid and completed gift of stock by the decedent to his wife over two years prior to his death in 1921 was consummated, no part of which should be included in the decedent's gross estate, the court holding that the decedent intended to do whatever was necessary to complete the gift to his wife, and made sufficient delivery effectually to pass legal title where the transfers were recorded on the corporate books and new certificates issued in the wife's name, part of which certificates were substituted for the old certificates of stock used as collateral by banks and the balance placed in the decedent's safe-deposit box to which the agent of his wife had access. That the wife had given to the decedent, prior to the transfers, power of attorney to sign or endorse the stock and to negotiate purchase and sale thereof, which power the decedent never exercised, or that the income thereof was used in the payment of the household expenses and for maintenance of a yacht, under powers of attorney, does not establish that the decedent did not part with dominion and control over the stock. (*Norman W. Bingham, jr., et als., executors of the will of King Upton* v. *Thomas W. White, collector.* District court of the U. S., district of Massachusetts.)

Share of 1919 profits credited to a salesman in addition to a salary on the books of a corporation under a contract to share profits and losses during the contract upon an accounting at the termination of the contract, which was terminated in 1921 when the losses exceeded the profits, is not deductible in 1919, since under the terms of the contract the corporation never actually became liable for any amount of profits. (*United States of America* v. *Block & Kohner Mercantile Co., a corporation.* U. S. district court, eastern division of the eastern judicial district of Missouri.)